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# The failure of Credit Suisse

While the bank was indeed mismanaged, its collapse also reveals a system of regulation with as many holes as a Swiss cheese

In the wake of the collapses of Silicon Valley Bank and Credit Suisse (CS), the narrative that the two banks were special cases – so one could therefore return to business as usual – quickly gained ground. On closer inspection, however, this is far from being valid, at least for CS.

True, the bank has a long history of mismanagement: involvement with the Bulgarian mafia from 2004 to 2007, dubious dealings involving a British subsidiary in Mozambique in 2011 and losses at the hedge funds Archegos and Greensill in 2021. And it is probably not wrong to report a 'general rip-off mentality' among its managers.

## Under supervision

Recent problems should not, however, be reduced to past mistakes – or excessive management remuneration. The bank was not operating in a vacuum: it was under the constant supervision and monitoring of the Swiss Financial Market Supervisory Authority (FINMA) and the Swiss National Bank (SNB). In the event of chronic concerns, it was up to these institutions to urge remedial action.

Yet, in its financial-stability report last September, referring also to UBS, the SNB declared:

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> The capital position of both banks has improved further since the last Financial Stability Report. The capital ratios of Credit Suisse and UBS exceed the requirements under the Swiss 'too big to fail' regulations and are above average by international comparison. The report also presented very positively the outcomes of stress tests conducted by the SNB: 'the results of the stress scenario analysis

indicate that, thanks to their capital buffers, the two globally active Swiss banks are well placed to cope with severely adverse developments in economic and financial conditions.'

And despite all the mismanagement, the CS annual report published last month showed the bank still had 45 bn Swiss francs in equity at the end of 2022. Its auditors, PricewaterhouseCoopers, confirmed in that report that everything was in order. Since CS was sold to UBS shortly afterwards for only 3 bn Swiss francs, the question arises as to how such a massive loss in value – in less than three months – might be explained.

## The problem lies with the authorities

What were the real causes of the bank's collapse? There is no doubt it was triggered by massive withdrawals by depositors who feared losing their money in the face of so much negative news. But this was also addressed by the SNB in its stability report. In the event of 'liquidity shocks', it said it would provide additional liquidity, in its capacity as 'lender of last resort', against sufficient collateral.

This corresponds to the textbook procedure for a banking crisis, based on distinguishing solvency and liquidity problems. A bank that is insolvent, being over-indebted, must be closed or restructured immediately. A solvent bank, on the other hand, which becomes illiquid due to a withdrawal of deposits triggered by psychological factors, presents a scenario for the central bank to step in as a lender of last resort. As long as the bank is sufficiently capitalised, the central bank should be able to keep it alive with liquidity assistance.

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If the accounts are correct, CS was a solvent bank with above-average capital adequacy, at least until the end of 2022. As late as 15 March 2023, the SNB and FINMA explicitly affirmed that CS met the capital and liquidity requirements imposed on systemically important banks. If necessary, the SNB would provide liquidity.

The fundamental problem, therefore, is that the Swiss authorities were not able to rescue CS, despite their statements to the contrary, resulting in a huge loss of capital for shareholders and subordinated debt holders. For Switzerland, this raises the question of how to reform its authorities, which were incapable of recognising the bank's problems and ensuring its survival, so that they may adequately supervise the new, extra-large UBS

and effectively stabilise it in the event of a run.

## A threat to global markets?

Beyond Switzerland, the collapse of CS shows that even an above-average capital base is no guarantee of a bank's stability in a crisis – and that stress tests, however important, should not be overestimated. If the Swiss authorities were unable to deal with a serious liquidity problem, moreover, couldn't something similar happen in other countries?

So there is still no reason to sound the all-clear on global financial markets. The abrupt rise in central-bank policy rates since last year is a major challenge for the banking system. During the years of low interest rates, many institutions were generous in granting long-term loans, especially for housing, which are now yielding low returns. At the same time, they have been refinancing themselves with very short-term deposits.

As long as depositors remain calm, this is not a problem. But if confidence in a bank wanes, the only way for it to attract new funds is to pay the currently very high short-term interest rates for them. A liquidity problem can then quickly become a solvency issue. This creates a conflict of objectives for central banks. Still unchecked 'core' inflation (excluding energy and food) argues for maintenance of a restrictive monetary policy, but this increases tensions in the financial system.

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This trade-off cannot be resolved, but central banks can mitigate it by working with governments to make clear that solvent institutions can count on full liquidity support. In particular, the scope of government deposit insurance could be increased, at least temporarily, to reduce the risk of destabilising withdrawals in the first place.

Given the complexity of global financial institutions, the more fundamental question arises as to how outsiders entrusting their money to a bank should be able to judge its quality and so impose what the literature calls 'market discipline'. The World Bank defines this thus: 'market discipline refers to the process by which market participants, such as depositors and shareholders, monitor banks' risks and take action to limit excessive risk-taking.'

Customers can certainly monitor their pizza bakers, but when it comes to banks, depositors are no more able to monitor the safety of the service than are the passengers of an airline. The design of institutional arrangements that provide absolutely safe assets for large depositors is therefore an open question.

The option of holding deposits directly with the central bank – a central-bank digital currency – would be very welcome. But so far, the European Central Bank's plans for a digital euro envisage an upper limit of only € 3,000, to avoid the bypassing ('disintermediation') of the banking system.

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